

General Information Letter: A small partnership exempt from the partnership procedures created by the Tax Equity and Fiscal Responsibility Act is a partnership for Illinois replacement tax purposes.

October 25, 2007

Dear:

This is in response to your letter dated September 14, 2007, in which you request a ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at [www. tax.illinois.gov](http://www.tax.illinois.gov).

In your letter you have stated the following:

At this time COMPANY LLLP requests a second review of the request for abatement of penalties and interest for the above years as well as a review of the requirement of the above LLLP to file IL Form 1065 and pay Illinois Replacement Tax. A completed IL-2848 Power of Attorney is enclosed.

In July 2006 the above LLLP became aware of the requirement of partnerships to pay replacement tax in the state of Illinois. At that time the LLLP filed IL-1065, Partnership Replacement Tax Returns, for years 2000-2005 and paid the replacement tax due with the returns, where applicable.

The LLLP was assessed penalties and interest for years 2001, 2003, 2004 and 2005. Upon receipt of these assessments the LLLP request that the penalties and interest be abated due to reasonable cause (Exhibit A). The Illinois department of revenue denied the first request for the abatement of penalties and interest. Further research into this matter has led us to conclude that not only should the penalties and interest be abated but also the replacement tax paid should be refunded for the years in question. The following facts and arguments are provided in support of this conclusion.

The LLLP is organized under the laws of the state of STATE. All members of the LLLP are individuals and are residents of the state of STATE. For the tax years in question, years 2000-2005, the members of the LLLP were notified of Illinois source income using a footnote attached to their federal schedule K-1. The members reported and paid tax on their distributive share of Illinois source income passed thru to them from the LLLP by filing nonresident Illinois individual income tax returns and paid any resulting tax at the individual level.

The instructions for the IL 1065 state that a partnership that has elected under IRC Section 761, to be excluded from the partnership provisions of the IRC is also excluded for purposes of the IITA (Exhibit B). The LLLP did not elect under IRC Section 761, to be excluded from the partnership provisions of the IRC, as they could not make this election since they meet the exception to the definition of a "partnership" for small partnerships under IRC Section 6231(a)(1)(B)(Exhibit C). In general, this section states, the term "partnership" does not include a partnership if the partnership has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate,

and each partner's share of each partnership item is the same as such partner's share of every other item. A husband and wife, and their estates, are treated as one partner for this purpose. Based on this section, a partnership that meets the small partnership exception is not required to file a partnership tax return, however, the filing of a federal partnership return, for administrative ease, by a small partnership does not negate its definition as a small partnership.

The Illinois Department of Revenue IT 92-0057 (Exhibit D), dated 3/3/1992, response to the question regarding conforming with federal tax treatment leads one to surmise that Illinois conforms to federal tax treatment in all areas except for those outlined in the response. As previously stated, COMPANY LLLP is a small partnership under IRC Section 6231(a)(1)(B). It is our contention, that since IRC Section 6231(a)(1)(B) is not mentioned in IT 92-0057 as an exception to conforming with federal tax treatment the state of Illinois should recognize COMPANY LLLP as a small partnership for Illinois purposes just as they recognize the election under IRC Section 761. Therefore, the LLLP should not have to file an Illinois Replacement Tax Return nor pay Illinois Replacement Tax.

Consequently, the LLLP is hereby requesting that the taxes paid in the following years be refunded:

<u>Tax Year Ended</u>	<u>Tax Paid</u>
12-31-2001	\$40.00
12-31-2003	1,232.00
12-31-2004	88.00
12-31-2005	910.00

In the event that the Department does not concur with our findings that this LLLP is not required to file an Illinois Replacement Tax Return because it meets the definition of a small partnership in IRC Section 6231(a)(1)(B), we respectfully request that the penalties and interest be abated due to reasonable cause. First, based on the response, IT 02-0057, by the Illinois Department of Revenue, regarding conforming with federal tax treatment, it can be concluded that the Illinois Department of Revenue would also conform with the assessment of penalties relative to an entity that meets the definition of a small partnership under IRC Section 6231(a)(1)(B). Internal Revenue Procedures 84-35 (Exhibit E) states, in part, that a domestic partnership composed of 10 or fewer partners and coming within the exceptions outlined in section 6231(a)(1)(B) of the Code will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6693 for the failure to file a complete or timely return. Second, based on the fact that the LLLP merely allocated Illinois source income to the partners through a footnote attached to the member's federal schedule K-1, it is clear the LLLP believed it met the definition of a small partnership under IRC Section 6231(a)(1)(B) and further believed that Illinois would conform with the IRC and therefore, would not be required to file a partnership return in the state of Illinois. Third, upon review of partnership filing requirements in virtually all states we concluded that the state of Illinois is one of the few states that imposes a charge at the partnership level and, to the best of our knowledge, is the only state that imposes an income tax at the partnership level. Finally, the LLLP and its members did not willfully or maliciously

neglect their filing requirements but truly believed they had filed all appropriate forms and paid any and all tax due to the state of Illinois for the years in question.

## **Response**

Sections 6221 through 6232, comprising Subchapter C of Chapter 63 of the Internal Revenue Code, were enacted by the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248. The purpose of Subchapter C was to provide that the tax treatment of "partnership items" must be determined at the partnership level, rather than at the partner level, and to provide procedures for review and contest of partnership items at the partnership level.

Section 6231(a) of the Internal Revenue Code provides, in part:

For purposes of this subchapter –

(1) Partnership

(A) In general Except as provided in subparagraph (B), the term "partnership" means any partnership required to file a return under section 6031(a).

(B) Exception for small partnerships

(i) In general The term "partnership" shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

Accordingly, the "small partnership" exemption in Section 6231(a)(1)(B) of the Internal Revenue Code applies only for purposes of the special partnership procedures in Subchapter C. Qualification as a small partnership under that section does not mean that the entity is not a "partnership" for any other purpose of the Internal Revenue Code. To the contrary, since Section 6231(a)(1)(A) provides that Subchapter C applies only to partnerships required to file returns under Section 6031, the existence of the exemption in Section 6231(a)(1)(B) implies that a "small partnership" is subject to the return requirements under Section 6031. Otherwise, there would be no need for the exemption.

Rev. Proc. 84-35 also does nothing to support your contention that a small partnership is not a partnership subject to reporting requirements under the Internal Revenue Code. Rather, that procedure clearly states that small partnerships are required to file returns, but that Congress intended to exempt them from penalty for failure to file if the partners properly reported and paid tax on all partnership items, so that the failure resulted in no detriment to the government. Again, this special exemption would not be necessary if small partnerships were exempt from filing partnership returns.

Section 1501(a)(16) of the Illinois Income Tax Act (35 ILCS 5/1501) provides, in part:

The term "partnership" includes any entity, including a limited liability company formed under the Illinois Limited Liability Company Act, classified as a partnership for federal income tax purposes.

Accordingly, your letter makes it clear that COMPANY LLLP is a partnership for federal income tax purposes, and is therefore a partnership for Illinois income tax purposes. The fact that COMPANY

LLLP reported to its members on federal Schedules K-1 that it had Illinois-sourced income for the years 2000 through 2005 proves that it knew it was a partnership for income tax purposes and that it had Illinois-sourced income, and that its failure to file Illinois returns and pay replacement tax for those years resulted from a failure to familiarize itself with Illinois law. Nothing in your letter provides a justification for that failure.

Finally, Section 3-8 of the Uniform Penalty and Interest Act (35 ILCS 735/3-8) provides:

The penalties imposed under the provisions of Sections 3-3 [late filing and late payment], 3-4 [failure to file information returns], 3-5 [negligence], and 3-7.5 [cost of collection penalty] of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. A taxpayer may protest the imposition of a penalty under Section 3-3, 3-4, 3-5, or 3-7.5 on the basis of reasonable cause without protesting the underlying tax liability.

This provision, by its terms, does not apply to interest imposed on an underpayment under Section 3-2 of the Uniform Penalty and Interest Act. Accordingly, there is no abatement of interest for "reasonable cause."

If you wish to contest the imposition of the replacement tax, COMPANY LLLP must file amended returns for the years in question, using Forms IL-1065-X, claiming a refund. If the claims are denied, the notices of denial will contain information on your rights to protest the denial and seek review.

If you wish to seek abatement of penalties and interest without contesting the tax liability, or even after unsuccessfully contesting the liability, on any grounds, you may petition the Board of Appeals using Form BOA-1, which is available on the Department's web site at <http://www.iltax.com/taxforms/misc/boa/boa1.pdf>.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton  
Deputy General Counsel – Income Tax